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**PORTFOLIO RISK DIVERSIFICATION,
COHERENT RISK MEASURES AND RISK
MAPPING, RISK CONTRIBUTION
ANALYSIS AND THE SETTING OF RISK
LIMITS**

A thesis presented in partial fulfillment of the requirements for the degree
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Abstract

This study aims to investigate the nature and sources of portfolio risks during normal as well as abnormal market conditions. The benefits of portfolio diversification will be studied first. Portfolio risk as measured by the volatility and beta will be calculated as the number of the positions is increased until the marginal diversification benefits obtained are at its optimal. Other measures based on statistical measures such as quantiles, quantile differences and quantile ratios for central tendency and asymmetry presence and significance of extreme events of skewness and kurtosis will also be used. This study is conducted on the daily data for the period August 9, 1998 to June 30, 2003, for 25 stock markets worldwide: Australia, Brazil, Chile, France, Germany, Hong Kong, Japan, India, Indonesia, Ireland, Israel, Italy, Mexico, New Zealand, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom and United States. Based on the theory of central limit theorem (*CLT*) and hence jointly normal distributions, the relationship between portfolio diversification and value at risk (*VaR*) as a coherent risk measure is examined.

Diversification benefits based on two simulation models namely: the geometric Brownian motion (GBM) and Fréchet random walk (FRW) which serve as the ideal models are also investigated.

The second part of the study focuses on the main sources of risk or risk hot spots in a portfolio using component $VaR(VaR_C)$, incremental $VaR(IVaR)$, and delta or marginal ($DVaR$). Finally, the portfolio risk will be monitored using a risk mapping or risk decomposition method. The risk of a given position is mapped onto a much smaller number of primary risk factors. In this study, individual country's stock index will be used as proxy for equities, government bond index and risk free rate for fixed interest, spot foreign exchange rate and forward one month, three month and one year exchange rate and gold and crude oil for commodities.

In general, the results for the tail-risk measures are similar to what has been found for the center of the portfolio risk measures and covariance plays a significant role in the assessment of the risk inherent to real portfolios based on the greater diversification benefits gained from the two simulated models, whose log-returns were generated independently. Diversification “works” well under normal market conditions.

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Table of Contents

Abstract	ii
Acknowledgements	iv
Table of Contents	v
List of Tables	xiii
List of Figures	xxxiii
 Introduction	 1
 Part One: Literature Review	 2
Chapter 1: Merits of International Diversification	3
1.1 Benefits of Domestic Diversification Using Naïve Diversification	3
1.2 Comovements between World Equity Markets	6
1.3 Integration of World Equity Markets	12
1.4 Coherent Risk Measures and Value at Risk (VaR)	16
1.5 Conclusions	18
 Chapter 2: The Assumption of Normal Distribution and the Use of Linear VaR Models	 20
2.1 Justification for Normal Distribution: In Theory and In Practice	20
2.1.1 The Capital Asset Pricing Model and the Random Walk Hypothesis	20
2.1.2 The Central Limit Theorem	21
2.1.3 $N(0,1)$ Properties	22
2.2 Linear VaR Models: Variance/Covariance VaR	22
2.3 Hot Spots, Incremental VaR , Component VaR and Delta VaR	24
2.4 Risk Contributions	28
2.4.1 Absolute and Marginal Risk Contributions	28
2.4.2 Retained Risk Ratios	32
2.4.3 Absolute Risk Contributions and Capital Allocation	34

2.4.4 Marginal Risk Contributions and Risk-Based Pricing	34
2.5 Conclusions	35
Chapter 3: VaR , Risk Factors and the Need for Risk Decomposition	36
3.1 Limitations of Variance/Covariance VaR	36
3.2 The Risk Mapping Process	37
3.3 Approaches to Selection of Risk Factors	38
3.4 Conclusions	40
Part Two: Data & Methodology	41
Chapter 4: Data Description	42
4.1 Raw Data	42
4.2 Market Opening and Closing Times	44
4.3 Emerging and Developed Markets	46
4.4 Data Transformation	46
4.5 The Basis for Risk Factors' Selection	48
Chapter 5: Assessing Diversification Benefits	52
5.1 The Markowitz Model	52
5.2 General Measures of Central Tendency Using Quantile Functions	55
5.3 Asymmetry and Extreme Events Capture by Skewness and Kurtosis	57
5.4 Variance/Covariance VaR	61
5.4.1 Holding Period and Confidence Interval	62
5.4.2 Sample Size	63
5.4.3 Calculating Portfolio Values for Positions in Assets	64
5.4.4 Implementing VaR Using Variance/Covariance Approach	65
5.5 Initial VaR Theory and Approaches by Garman, Litterman and Dowd	66
5.5.1 Individual VaR Forecasts	66
5.5.2 Undiversified VaR Forecasts	66
5.5.3 Diversified VaR Forecasts	68
5.5.4 Marginal VaR Forecasts	68

5.5.5 Incremental VaR Forecasts	71
5.5.6 Component VaR Forecasts	74
5.6 Implementing the Historical VaR Methodology	78
5.7 Expected Shortfall Methodology as an Extension to VaR	80
 Chapter 6: Risk Mapping Using Multi-Factor Models	 83
6.1 An Overview of the Multi-Factor Risk Mapping Modeling Procedure	83
6.2 An Overview of the Multi-Factor Model	84
6.3 The Rate of Return of the Portfolio in Terms of the Factors	85
6.4 The Factor Loadings	86
6.5 The Linear Factor Sensitivity Measures	86
6.6 The Residual Risk Term of the Multi-Factor Model	87
6.7 The Multi-Factor Model Presented in the Risk-Premium Form	88
 Part Three: Results & Analysis	 90
 Chapter 7: The Empirical Analysis of the Effects of Diversification	 91
7.1 Composition of the Portfolios	92
7.2 Overview of the Simulation Reference Models	94
7.3 Overview of this Investigation	96
7.3.1 Overview of the Method and Risk Measures Estimated in this Investigation	96
7.3.2 Presentation of the Estimated Risk Measures and Ratios	99
7.4 The Results for the Risk Measurements and the Diversification Studies	100
7.4.1 Results for Relative and Absolute Dispersion Reduction of the Volatility	100
7.4.2 Results for Aggregate Portfolio Risk Measurements and Diversification Effects	102
7.4.3 Results for Historical Portfolio Risk Measurements	105
7.4.4 Results for Relative and Absolute Risk Reduction Ratios	106
7.4.5 Results for Difference in Portfolio Risk Measurements	108
7.4.6 Results for Beta Estimates	110
7.4.7 Results for Component Portfolio Risk Measurements	110
7.4.8 Results for Positions to Component Risk Reduction Ratios	112

7.4.9 Results for Incremental Portfolio Risk Measurements	114
Chapter 8: Results for Risk Mapping	116
8.1 The Results of the Risk Mapping	118
Chapter 9: Conclusions and Future Research	120
References	124
Appendices	
Appendix A1 – Dispersion reduction as a function of the number of positions in the domestic portfolios	A1.01-A1.09
Appendix A2 – Dispersion reduction as a function of the number of positions in the foreign portfolios	A2.01-A2.04
Appendix A3 – Dispersion reduction as a function of the number of positions for the Fréchet random walk model and geometric Brownian motion model	A3.01
Appendix B1 – Aggregate portfolio risk estimates for domestic portfolios	B1.01-B1.13
Appendix B2 – Aggregate portfolio risk estimates for foreign portfolios	B2.01-B2.05
Appendix B3 – Aggregate portfolio risk estimates for Fréchet random walk model and geometric Brownian motion model	B3.01
Appendix C1 – Position, diversified and undiversified VAR/COV VaR@95% confidence level estimates for domestic portfolios	C1.01-C1.07
Appendix C2 – Position, diversified and undiversified VAR/COV VaR@95% confidence level estimates for foreign portfolios	C2.01-C2.03
Appendix C3 – Position, diversified and undiversified VAR/COV VaR@95% confidence level estimates for Fréchet random walk model and geometric Brownian motion model	C3.01
Appendix D1- Incremental historical VaR estimated from delta VaR for domestic portfolios	D1.01-D1.07
Appendix D2 – Incremental historical VaR estimated from delta VaR for foreign portfolios	D2.01-D2.03
Appendix D3 – Incremental historical VaR estimated from delta VaR for Fréchet random walk model and geometric Brownian motion model	D3.01

Appendix E1 – Risk reduction as a function of the number of positions for domestic portfolios	E1.01-E1.13
Appendix E2 – Risk reduction as a function of the number of positions for foreign portfolios	E2.01-E2.05
Appendix E3 – Risk reduction as a function of the number of positions for Fréchet random walk model and geometric Brownian motion model	E3.01
Appendix F1 – Difference between estimates based on aggregate portfolio and sum individual positions for domestic portfolios	F1.01-F1.07
Appendix F2 – Difference between estimates based on aggregate portfolio and sum individual positions for foreign portfolios	F2.01-F2.03
Appendix F3 – Difference between estimates based on aggregate portfolio and sum individual positions for Fréchet random walk and geometric Brownian motion	F3.01
Appendix G1 – Estimates of component VaR@95% confidence level for domestic portfolios	G1.01-G1.25
Appendix G2 – Estimates of component VaR@95% confidence level for domestic portfolios	G2.01-G2.10
Appendix G3 – Estimates of component VaR@95% confidence level for Fréchet random walk model and geometric Brownian motion model	G3.01-G3.02
Appendix H1 – Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for domestic portfolios	H1.01-H1.25
Appendix H2 – Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for foreign portfolios	H2.01-H2.10
Appendix H3 – Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Fréchet random walk model and geometric Brownian motion model	H3.01-H3.02
Appendix I1 – Individual positions by market capitalization of 25 countries and industry classification	I1.01-I1.25
Appendix I2 – Individual positions by market capitalization of the foreign portfolios and industry classification	I2.01-I2.10
Appendix J – Geometric and arithmetic averages % for dispersion reduction as a function of the number of positions in portfolios	J1.01
Appendix J – Geometric and arithmetic averages % for dispersion reduction as function of the number of positions in portfolios	J3.01

Appendix K – Geometric averages for position, diversified, undiversified VAR/COV VaR@95% confidence level estimates for portfolios	K1.01
Appendix K – Geometric averages for position, diversified, undiversified VAR/COV VaR@95% confidence level estimates for portfolios	K3.01
Appendix L – Arithmetic averages for incremental historical VaR estimated from delta VaR for portfolios	L1.01
Appendix L – Arithmetic averages for incremental historical VaR estimated from delta VaR for portfolios	L3.01
Appendix M – Arithmetic and geometric averages % for risk reduction as a function of the number of positions in portfolios	M1.01
Appendix M – Arithmetic and geometric averages % for risk reduction as a function of the number of positions in portfolios	M3.01
Appendix N – Arithmetic averages % for difference between estimates based on aggregate portfolio and sum individual positions for portfolios	N1.01
Appendix N – Arithmetic averages % for difference between estimates based on aggregate portfolio and sum individual positions for portfolios	N3.01
Appendix O – Arithmetic averages for estimates of component VaR@95% confidence level for portfolios	O1.01
Appendix O – Arithmetic averages for estimates of component VaR@95% confidence level for portfolios	O3.01
Appendix P – Arithmetic averages for estimates position VaR@95/component VaR@95 ratios	P1.01
Appendix P – Arithmetic averages for estimates position VaR@95/component VaR@95 ratios	P3.01
Appendix Q – Geometric averages % for estimates position VaR@95/component VaR@95 ratio for portfolios	Q1.01
Appendix Q – Geometric averages % for estimates position VaR@95/component VaR@95 ratio for portfolios	Q3.01
Appendix R – Variance/covariance VaR at the 95% confidence level for both domestic and foreign portfolios	R1
Appendix R – Variance/covariance VaR confidence level for both Fréchet random walk model and geometric Brownian motion model	R3 & S3
Appendix S – Maximum portfolio loss for both domestic and foreign portfolios	S1

Appendix S – Maximum portfolio loss for both Fréchet random walk model and geometric Brownian motion model	R3 & S3
Appendix T – Historical VaR at the 95% confidence level for both domestic and foreign portfolios	T1
Appendix T – Historical VaR @ 95% confidence level for both Fréchet random walk model and geometric Brownian motion model	T3 & U3
Appendix U – Expected shortfall at the 95% confidence level for both domestic and foreign portfolios	U1
Appendix U – Expected shortfall @ 95% confidence level for both Fréchet random walk model and geometric Brownian motion model	T3 & U3
Appendix V – Ratio of diversified portfolio VaR to aggregate VaR from individual positions for both domestic and foreign portfolios	V1
Appendix V – Ratio of diversified portfolio VaR to aggregate VaR from individual positions for both Fréchet random walk model and geometric Brownian motion model	V3 & W3
Appendix W – Component VaR at the 95% confidence level for both domestic and foreign portfolios	W1
Appendix W – Component VaR @ 95% confidence level for both Fréchet random walk model and geometric Brownian motion model	V3 & W3
Appendix X – Ratio of position VaR at the 95% confidence level to component VaR at the 95% confidence level for domestic and foreign portfolios	X1
Appendix X – Ratio of position VaR @ 95% confidence level to component VaR @ 95% confidence level for both Fréchet random walk model and geometric Brownian motion model	X3
Appendix Y – Defining the country code and the classification of countries into developed or emerging	Y1
Appendix Z1 – Average beta estimates for domestic portfolios	Z1.01-Z1.25
Appendix Z2 – Average beta estimates for foreign portfolios	Z2.01-Z2.10
Appendix Z3 – Beta estimates for Fréchet random walk model and geometric Brownian motion model	Z3.01

Appendix AA

AA.1-AA.4

Appendix AB2 – Average weighting factor betas for mixed-foreign portfolios

AB2.01-AB2.03

Appendix AC2 – Average risk measurements for mixed-foreign portfolios

AC2.01-AC2.04

List of Tables

1.1 Portfolio diversification effects	6
1.2 Stock price index percentage changes in major markets: Calendar year 1987 and October 1987	14
4.1 Exchange rate data	44
4.2 Market opening and closing times	45
4.3 Fixed interest – bond index, risk free rate or close estimates	49
4.4 Foreign exchange – 1 month, 3 months, and 1 year forward rates	50
4.5 Commodities – gold, crude oil	51
5.1 VaR calculation for various confidence levels: One-tail test based on the normal distribution	63
7.1 Industry categories for equities	93
8.1 Proxy risk factors selected for the risk mapping	117
8.2 Average relative risk measurement ratios	119
A1.01 Dispersion reduction as a function of the number of positions for Australia	A1.01
A1.02 Dispersion reduction as a function of the number of positions for Brazil	A1.01
A1.03 Dispersion reduction as a function of the number of positions for Chile	A1.01
A1.04 Dispersion reduction as a function of the number of positions for France	A1.02
A1.05 Dispersion reduction as a function of the number of positions for Germany	A1.02
A1.06 Dispersion reduction as a function of the number of positions for Hong Kong	A1.02
A1.07 Dispersion reduction as a function of the number of positions for Japan	A1.03
A1.08 Dispersion reduction as a function of the number of positions for India	A1.03
A1.09 Dispersion reduction as a function of the number of positions for Indonesia	A1.03
A1.10 Dispersion reduction as a function of the number of positions for Ireland	A1.04
A1.11 Dispersion reduction as a function of the number of positions for Israel	A1.04
A1.12 Dispersion reduction as a function of the number of positions for Italy	A1.04
A1.13 Dispersion reduction as a function of the number of positions for Mexico	A1.05
A1.14 Dispersion reduction as a function of the number of positions for New Zealand	

	A1.05
A1.15 Dispersion reduction as a function of the number of positions for Singapore	A1.05
A1.16 Dispersion reduction as a function of the number of positions for South Africa	A1.06
A1.17 Dispersion reduction as a function of the number of positions for South Korea	A1.06
A1.18 Dispersion reduction as a function of the number of positions for Spain	A1.06
A1.19 Dispersion reduction as a function of the number of positions for Sweden	A1.07
A1.20 Dispersion reduction as a function of the number of positions for Switzerland	A1.07
A1.21 Dispersion reduction as a function of the number of positions for Taiwan	A1.07
A1.22 Dispersion reduction as a function of the number of positions for Thailand	A1.08
A1.23 Dispersion reduction as a function of the number of positions for Turkey	A1.08
A1.24 Dispersion reduction as a function of the number of positions for United Kingdom	A1.08
A1.25 Dispersion reduction as a function of the number of positions for United States	A1.09
A2.01 Dispersion reduction as a function of the number of positions for foreign portfolios with the highest market capitalization	A2.01
A2.02 Dispersion reduction as a function of the number of positions for foreign portfolios with the second highest market capitalization	A2.01
A2.03 Dispersion reduction as a function of the number of positions for foreign portfolios with the third highest market capitalization	A2.01
A2.04 Dispersion reduction as a function of the number of positions for foreign portfolios with the fourth highest market capitalization	A2.02
A2.05 Dispersion reduction as a function of the number of positions for foreign portfolios with the fifth highest market capitalization	A2.02
A2.06 Dispersion reduction as a function of the number of positions for foreign portfolios with the sixth highest market capitalization	A2.02
A2.07 Dispersion reduction as a function of the number of positions for foreign portfolios with the seventh highest market capitalization	A2.03
A2.08 Dispersion reduction as a function of the number of positions for foreign portfolios with the eighth highest market capitalization	A2.03

A2.09 Dispersion reduction as a function of the number of positions for foreign portfolios with the ninth highest market capitalization	A2.03
A2.10 Dispersion reduction as a function of the number of positions for foreign portfolios with the tenth highest market capitalization	A2.04
A3.01 Dispersion reduction as a function of the number of positions for the Fréchet random walk model	A3.01
A3.02 Dispersion reduction as a function of the number of positions for the geometric Brownian motion model	A3.02
B1.01 Aggregate portfolio risk estimates for Australia	B1.01
B1.02 Aggregate portfolio risk estimates for Brazil	B1.01
B1.03 Aggregate portfolio risk estimates for Chile	B1.02
B1.04 Aggregate portfolio risk estimates for France	B1.02
B1.05 Aggregate portfolio risk estimates for Germany	B1.03
B1.06 Aggregate portfolio risk estimates for Hong Kong	B1.03
B1.07 Aggregate portfolio risk estimates for India	B1.04
B1.08 Aggregate portfolio risk estimates for Indonesia	B1.04
B1.09 Aggregate portfolio risk estimates for Ireland	B1.05
B1.10 Aggregate portfolio risk estimates for Israel	B1.05
B1.11 Aggregate portfolio risk estimates for Italy	B1.06
B1.12 Aggregate portfolio risk estimates for Japan	B1.06
B1.13 Aggregate portfolio risk estimates for Mexico	B1.07
B1.14 Aggregate portfolio risk estimates for New Zealand	B1.07
B1.15 Aggregate portfolio risk estimates for Singapore	B1.08
B1.16 Aggregate portfolio risk estimates for South Africa	B1.08
B1.17 Aggregate portfolio risk estimates for South Korea	B1.09
B1.18 Aggregate portfolio risk estimates for Spain	B1.09
B1.19 Aggregate portfolio risk estimates for Sweden	B1.10
B1.20 Aggregate portfolio risk estimates for Switzerland	B1.10
B1.21 Aggregate portfolio risk estimates for Taiwan	B1.11
B1.22 Aggregate portfolio risk estimates for Thailand	B1.11
B1.23 Aggregate portfolio risk estimates for Turkey	B1.12
B1.24 Aggregate portfolio risk estimates for United Kingdom	B1.12
B1.25 Aggregate portfolio risk estimates for United States	B1.13

B2.01 Aggregate portfolio risk estimates for companies with highest market capitalization	B2.01
B2.02 Aggregate portfolio risk estimates for companies with second highest market capitalization	B2.01
B2.03 Aggregate portfolio risk estimates for companies with third highest market capitalization	B2.02
B2.04 Aggregate portfolio risk estimates for companies with fourth highest market capitalization	B2.02
B2.05 Aggregate portfolio risk estimates for companies with fifth highest market capitalization	B2.03
B2.06 Aggregate portfolio risk estimates for companies with sixth highest market capitalization	B2.03
B2.07 Aggregate portfolio risk estimates for companies with seventh highest market capitalization	B2.04
B2.08 Aggregate portfolio risk estimates for companies with eighth highest market capitalization	B2.04
B2.09 Aggregate portfolio risk estimates for companies with ninth highest market capitalization	B2.05
B2.10 Aggregate portfolio risk estimates for companies with tenth highest market capitalization	B2.05
B3.01 Aggregate portfolio risk estimates for Fréchet random walk model	B3.01
B3.02 Aggregate portfolio risk estimates for geometric Brownian motion model	B3.02
C1.01 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Australia	C1.01
C1.02 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Brazil	C1.01
C1.03 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Chile	C1.01
C1.04 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for France	C1.01
C1.05 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Germany	C1.02
C1.06 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Hong Kong	C1.02

C1.07 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Japan	C1.02
C1.08 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for India	C1.02
C1.09 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Indonesia	C1.03
C1.10 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Ireland	C1.03
C2.01 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with highest market capitalization	C2.01
C2.02 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with second highest market capitalization	C2.01
C2.03 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with third highest market capitalization	C2.01
C2.04 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with fourth highest market capitalization	C2.01
C2.05 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with fifth highest market capitalization	C2.02
C2.06 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with sixth highest market capitalization	C2.02
C2.07 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with seventh highest market capitalization	C2.02
C2.08 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with eighth highest market capitalization	C2.02
C2.09 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with ninth highest market capitalization	C2.03
C2.10 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for companies with tenth highest market capitalization	C2.03
C3.01 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for Fréchet random walk model	C3.01
C3.02 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for geometric Brownian motion model	C3.01
D1.01 Incremental historical VaR estimated from delta VaR for Australia	D1.01
D1.02 Incremental historical VaR estimated from delta VaR for Brazil	D1.01

D1.03 Incremental historical VaR estimated from delta VaR for Chile	D1.01
D1.04 Incremental historical VaR estimated from delta VaR for France	D1.01
D1.05 Incremental historical VaR estimated from delta VaR for Germany	D1.02
D1.06 Incremental historical VaR estimated from delta VaR for Hong Kong	D1.02
D1.07 Incremental historical VaR estimated from delta VaR for Japan	D1.02
D1.08 Incremental historical VaR estimated from delta VaR for India	D1.02
D1.09 Incremental historical VaR estimated from delta VaR for Indonesia	D1.03
D1.10 Incremental historical VaR estimated from delta VaR for Ireland	D1.03
D1.11 Incremental historical VaR estimated from delta VaR for Israel	D1.03
D1.12 Incremental historical VaR estimated from delta VaR for Italy	D1.03
D1.13 Incremental historical VaR estimated from delta VaR for Mexico	D1.04
D1.14 Incremental historical VaR estimated from delta VaR for New Zealand	D1.04
D1.15 Incremental historical VaR estimated from delta VaR for Singapore	D1.04
D1.16 Incremental historical VaR estimated from delta VaR for South Africa	D1.04
D1.17 Incremental historical VaR estimated from delta VaR for South Korea	D1.05
D1.18 Incremental historical VaR estimated from delta VaR for Spain	D1.05
D1.19 Incremental historical VaR estimated from delta VaR for Sweden	D1.05
D1.20 Incremental historical VaR estimated from delta VaR for Switzerland	D1.05
D1.21 Incremental historical VaR estimated from delta VaR for Taiwan	D1.06
D1.22 Incremental historical VaR estimated from delta VaR for Thailand	D1.06
D1.23 Incremental historical VaR estimated from delta VaR for Turkey	D1.06
D1.24 Incremental historical VaR estimated from delta VaR for United Kingdom	D1.06
D1.25 Incremental historical VaR estimated from delta VaR for United States	D1.07
D2.01 Incremental historical VaR estimated from delta VaR for companies with highest market capitalization	D2.01
D2.02 Incremental historical VaR estimated from delta VaR for companies with second highest market capitalization	D2.01
D2.03 Incremental historical VaR estimated from delta VaR for companies with third highest market capitalization	D2.01
D2.04 Incremental historical VaR estimated from delta VaR for companies with fourth highest market capitalization	D2.01
D2.05 Incremental historical VaR estimated from delta VaR for companies with fifth highest market capitalization	D2.02

D2.06 Incremental historical VaR estimated from delta VaR for companies with sixth highest market capitalization	D2.02
D2.07 Incremental historical VaR estimated from delta VaR for companies with seventh highest market capitalization	D2.02
D2.08 Incremental historical VaR estimated from delta VaR for companies with eighth highest market capitalization	D2.02
D2.09 Incremental historical VaR estimated from delta VaR for companies with ninth highest market capitalization	D2.03
D2.10 Incremental historical VaR estimated from delta VaR for companies with tenth highest market capitalization	D2.03
D3.01 Incremental historical VaR estimated from delta VaR for Fréchet random walk model	D3.01
D3.02 Incremental historical VaR estimated from delta VaR for geometric Brownian motion model	D3.01
E1.01 Risk reduction as a function of the number of positions in portfolio for Australia	E1.01
E1.02 Risk reduction as a function of the number of positions in portfolio for Brazil	E1.01
E1.03 Risk reduction as a function of the number of positions in portfolio for Chile	E1.02
E1.04 Risk reduction as a function of the number of positions in portfolio for France	E1.02
E1.05 Risk reduction as a function of the number of positions in portfolio for Germany	E1.03
E1.06 Risk reduction as a function of the number of positions in portfolio for Hong Kong	E1.03
E1.07 Risk reduction as a function of the number of positions in portfolio for Japan	E1.04
E1.08 Risk reduction as a function of the number of positions in portfolio for India	E1.04
E1.09 Risk reduction as function of the number of positions in portfolio for Indonesia	E1.05
E1.10 Risk reduction as function of the number of positions in portfolio for Ireland	

	E1.05
E1.11 Risk reduction as function of the number of positions in portfolio for Israel	E1.06
E1.12 Risk reduction as function of the number of positions in portfolio for Italy	E1.06
E1.13 Risk reduction as function of the number of positions in portfolio for Mexico	E1.07
E1.14 Risk reduction as function of the number of positions in portfolio for New Zealand	E1.07
E1.15 Risk reduction as function of the number of positions in portfolio for Singapore	E1.08
E1.16 Risk reduction as function of the number of positions in portfolio for South Africa	E1.08
E1.17 Risk reduction as a function of the number of positions in portfolio for South Korea	E1.09
E1.18 Risk reduction as function of the number of positions in portfolio for Spain	E1.09
E1.19 Risk reduction as function of the number of positions in portfolio for Sweden	E1.10
E1.20 Risk reduction as function of the number of positions in portfolio for Switzerland	E1.10
E1.21 Risk reduction as function of the number of positions in portfolio for Taiwan	E1.11
E1.22 Risk reduction as function of the number of positions in portfolio for Thailand	E1.11
E1.23 Risk reduction as function of the number of positions in portfolio for Turkey	E1.12
E1.24 Risk reduction as function of the number of positions in portfolio for United Kingdom	E1.12
E1.25 Risk reduction as function of the number of positions in portfolio for United States	E1.13
E2.01 Risk reduction as a function of the number of positions in portfolio for companies with highest market capitalization	E2.01
E2.02 Risk reduction as a function of the number of positions in portfolio for companies with second highest market capitalization	E2.01
E2.03 Risk reduction as a function of the number of positions in portfolio for companies with third highest market capitalization	E2.02

E2.04 Risk reduction as a function of the number of positions in portfolio for companies with fourth highest market capitalization	E2.02
E2.05 Risk reduction as a function of the number of positions in portfolio for companies with fifth highest market capitalization	E2.03
E2.06 Risk reduction as a function of the number of positions in portfolio for companies with sixth highest market capitalization	E2.03
E2.07 Risk reduction as a function of the number of positions in portfolio for companies with seventh highest market capitalization	E2.04
E2.08 Risk reduction as a function of the number of positions in portfolio for companies with eighth highest market capitalization	E2.04
E2.09 Risk reduction as a function of the number of positions in portfolio for companies with ninth highest market capitalization	E2.05
E2.10 Risk reduction as a function of the number of positions in portfolio for companies with tenth highest market capitalization	E2.05
E3.01 Risk reduction as a function of the number of positions in portfolio for Fréchet random walk model	E3.01
E3.02 Risk reduction as a function of the number of positions in portfolio for geometric Brownian motion model	E3.02
F1.01 Difference between estimates based on aggregate portfolio and sum individual positions for Australia	F1.01
F1.02 Difference between estimates based on aggregate portfolio and sum individual positions for Brazil	F1.01
F1.03 Difference between estimates based on aggregate portfolio and sum individual positions for Chile	F1.01
F1.04 Difference between estimates based on aggregate portfolio and sum individual positions for France	F1.01
F1.05 Difference between estimates based on aggregate portfolio and sum individual positions for Germany	F1.02
F1.06 Difference between estimates based on aggregate portfolio and sum individual positions for Hong Kong	F1.02
F1.07 Difference between estimates based on aggregate portfolio and sum individual positions for Japan	F1.02
F1.08 Difference between estimates based on aggregate portfolio and sum individual positions for India	F1.02

F1.09 Difference between estimates based on aggregate portfolio and sum individual positions for Indonesia	F1.03
F1.10 Difference between estimates based on aggregate portfolio and sum individual positions for Ireland	F1.03
F1.11 Difference between estimates based on aggregate portfolio and sum individual positions for Israel	F1.03
F1.12 Difference between estimates based on aggregate portfolio and sum individual positions for Italy	F1.03
F1.13 Difference between estimates based on aggregate portfolio and sum individual positions for Mexico	F1.04
F1.14 Difference between estimates based on aggregate portfolio and sum individual positions for New Zealand	F1.04
F1.15 Difference between estimates based on aggregate portfolio and sum individual positions for Singapore	F1.04
F1.16 Difference between estimates based on aggregate portfolio and sum individual positions for South Africa	F1.04
F1.17 Difference between estimates based on aggregate portfolio and sum individual positions for South Korea	F1.05
F1.18 Difference between estimates based on aggregate portfolio and sum individual positions for Spain	F1.05
F1.19 Difference between estimates based on aggregate portfolio and sum individual positions for Sweden	F1.05
F1.20 Difference between estimates based on aggregate portfolio and sum individual positions for Switzerland	F1.05
F1.21 Difference between estimates based on aggregate portfolio and sum individual positions for Taiwan	F1.06
F1.22 Difference between estimates based on aggregate portfolio and sum individual positions for Thailand	F1.06
F1.23 Difference between estimates based on aggregate portfolio and sum individual positions for Turkey	F1.06
F1.24 Difference between estimates based on aggregate portfolio and sum individual positions for United Kingdom	F1.06
F1.25 Difference between estimates based on aggregate portfolio and sum individual positions for United States	F1.07

F2.01 Difference between estimates based on aggregate portfolio and sum individual positions for companies with highest market capitalization	F2.01
F2.02 Difference between estimates based on aggregate portfolio and sum individual positions for companies with second highest market capitalization	F2.01
F2.03 Difference between estimates based on aggregate portfolio and sum individual positions for companies with third highest market capitalization	F2.01
F2.04 Difference between estimates based on aggregate portfolio and sum individual positions for companies with fourth highest market capitalization	F2.01
F2.05 Difference between estimates based on aggregate portfolio and sum individual positions for companies with fifth highest market capitalization	F2.02
F2.06 Difference between estimates based on aggregate portfolio and sum individual positions for companies with sixth highest market capitalization	F2.02
F2.07 Difference between estimates based on aggregate portfolio and sum individual positions for companies with seventh highest market capitalization	F2.02
F2.08 Difference between estimates based on aggregate portfolio and sum individual positions for companies with eighth highest market capitalization	F2.02
F2.09 Difference between estimates based on aggregate portfolio and sum individual positions for companies with ninth highest market capitalization	F2.03
F2.10 Difference between estimates based on aggregate portfolio and sum individual positions for companies with tenth highest market capitalization	F2.03
F3.01 Difference between estimates based on aggregate portfolio and sum individual positions for Fréchet random walk model	F3.01
F3.02 Difference between estimates based on aggregate portfolio and sum individual positions for geometric Brownian motion	F3.01
G1.01 Estimates of component VaR@95% confidence level for Australia	G1.01
G1.02 Estimates of component VaR@95% confidence level for Brazil	G1.02
G1.03 Estimates of component VaR@95% confidence level for Chile	G1.03
G1.04 Estimates of component VaR@95% confidence level for France	G1.04
G1.05 Estimates of component VaR@95% confidence level for Germany	G1.05
G1.06 Estimates of component VaR@95% confidence level for Hong Kong	G1.06
G1.07 Estimates of component VaR@95% confidence level for Japan	G1.07
G1.08 Estimates of component VaR@95% confidence level for India	G1.08
G1.09 Estimates of component VaR@95% confidence level for Indonesia	G1.09
G1.10 Estimates of component VaR@95% confidence level for Ireland	G1.10

G1.11 Estimates of component VaR@95% confidence level for Israel	G1.11
G1.12 Estimates of component VaR@95% confidence level for Italy	G1.12
G1.13 Estimates of component VaR@95% confidence level for Mexico	G1.13
G1.14 Estimates of component VaR@95% confidence level for New Zealand	G1.14
G1.15 Estimates of component VaR@95% confidence level for Singapore	G1.15
G1.16 Estimates of component VaR@95% confidence level for South Africa	G1.16
G1.17 Estimates of component VaR@95% confidence level for South Korea	G1.17
G1.18 Estimates of component VaR@95% confidence level for Spain	G1.18
G1.19 Estimates of component VaR@95% confidence level for Sweden	G1.19
G1.20 Estimates of component VaR@95% confidence level for Switzerland	G1.20
G1.21 Estimates of component VaR@95% confidence level for Taiwan	G1.21
G1.22 Estimates of component VaR@95% confidence level for Thailand	G1.22
G1.23 Estimates of component VaR@95% confidence level for Turkey	G1.23
G1.24 Estimates of component VaR@95% confidence level for United Kingdom	G1.24
G1.25 Estimates of component VaR@95% confidence level for United States	G1.25
G2.01 Estimates of component VaR@95% confidence level for companies with highest market capitalization	G2.01
G2.02 Estimates of component VaR@95% confidence level for companies with second highest market capitalization	G2.02
G2.03 Estimates of component VaR@95% confidence level for companies with third highest market capitalization	G2.03
G2.04 Estimates of component VaR@95% confidence level for companies with fourth highest market capitalization	G2.04
G2.05 Estimates of component VaR@95% confidence level for companies with fifth highest market capitalization	G2.05
G2.06 Estimates of component VaR@95% confidence level for companies with sixth highest market capitalization	G2.06
G2.07 Estimates of component VaR@95% confidence level for companies with seventh highest market capitalization	G2.07
G2.08 Estimates of component VaR@95% confidence level for companies with eighth highest market capitalization	G2.08
G2.09 Estimates of component VaR@95% confidence level for companies with ninth highest market capitalization	G2.09

G2.10 Estimates of component VaR@95% confidence level for companies with tenth highest market capitalization	G2.10
G3.01 Estimates of component VaR@95% confidence level for Fréchet random walk model	G3.01
G3.02 Estimates of component VaR@95% confidence level for geometric Brownian model	G3.02
H1.01 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Australia	H1.01
H1.02 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Brazil	H1.02
H1.03 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Chile	H1.03
H1.04 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for France	H1.04
H1.05 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Germany	H1.05
H1.06 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Hong Kong	H1.06
H1.07 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Japan	H1.07
H1.08 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for India	H1.08
H1.09 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Indonesia	H1.09
H1.10 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Ireland	H1.10
H1.11 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Israel	H1.11
H1.12 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Italy	H1.12
H1.13 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Mexico	H1.13
H1.14 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for New Zealand	H1.14

H1.15 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Singapore	H1.15
H1.16 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for South Africa	H1.16
H1.17 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for South Korea	H1.17
H1.18 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Spain	H1.18
H1.19 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Sweden	H1.19
H1.20 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Switzerland	H1.20
H1.21 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Taiwan	H1.21
H1.22 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Thailand	H1.22
H1.23 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for Turkey	H1.23
H1.24 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for United Kingdom	H1.24
H1.25 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for United States	H1.25
H2.01 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for companies with highest market capitalization	H2.01
H2.02 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for companies with second highest market capitalization	H2.02
H2.03 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for companies with third highest market capitalization	H2.03
H2.04 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for companies with fourth highest market capitalization	H2.04
H2.05 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for companies with fifth highest market capitalization	H2.05
H2.06 Estimates of the position VaR@95% confidence level to component VaR@95% confidence level ratio for companies with sixth highest market capitalization	H2.06

H2.07 Estimates of the position $\text{VaR}@95\%$ confidence level to component $\text{VaR}@95\%$ confidence level ratio for companies with seventh highest market capitalization	H2.07
H2.08 Estimates of the position $\text{VaR}@95\%$ confidence level to component $\text{VaR}@95\%$ confidence level ratio for companies with eighth highest market capitalization	H2.08
H2.09 Estimates of the position $\text{VaR}@95\%$ confidence level to component $\text{VaR}@95\%$ confidence level ratio for companies with ninth highest market capitalization	H2.09
H2.10 Estimates of the position $\text{VaR}@95\%$ confidence level to component $\text{VaR}@95\%$ confidence level ratio for companies with tenth highest market capitalization	H2.10
H3.01 Estimates of the position $\text{VaR}@95\%$ confidence level to component $\text{VaR}@95\%$ confidence level ratio for Fréchet random walk model	H3.01
H3.02 Estimates of the position $\text{VaR}@95\%$ confidence level to component $\text{VaR}@95\%$ confidence level ratio for geometric Brownian motion model	H3.02
I1.01 Australia	I1.01
I1.02 Brazil	I1.02
I1.03 Chile	I1.03
I1.04 France	I1.04
I1.05 Germany	I1.05
I1.06 Hong Kong	I1.06
I1.07 Japan	I1.07
I1.08 India	I1.08
I1.09 Indonesia	I1.09
I1.10 Ireland	I1.10
I1.11 Israel	I1.11
I1.12 Italy	I1.12
I1.13 Mexico	I1.13
I1.14 New Zealand	I1.14
I1.15 Singapore	I1.15
I1.16 South Africa	I1.16
I1.17 South Korea	I1.17
I1.18 Spain	I1.18
I1.19 Sweden	I1.19
I1.20 Switzerland	I1.20
I1.21 Taiwan	I1.21
I1.22 Thailand	I1.22

I1.23 Turkey	I1.23
I1.24 United Kingdom	I1.24
I1.25 United States	I1.25
I2.01 The highest market capitalization securities	I2.01
I2.02 The second highest market capitalization securities	I2.02
I2.03 The third highest market capitalization securities	I2.03
I2.04 The fourth highest market capitalization securities	I2.04
I2.05 The fifth highest market capitalization securities	I2.05
I2.06 The sixth highest market capitalization securities	I2.06
I2.07 The seventh highest market capitalization securities	I2.07
I2.08 The eighth highest market capitalization securities	I2.08
I2.09 The ninth highest market capitalization securities	I2.09
I2.010 The tenth highest market capitalization securities	I2.10
J1 Geometric and arithmetic percentages dispersion reduction for domestic portfolios	J1.01
J2 Geometric and arithmetic percentages dispersion reduction for foreign portfolios	J1.01
J3.01 Geometric and arithmetic percentages dispersion reduction for Fréchet random walk model	J3.01
J3.02 Geometric and arithmetic percentages dispersion reduction for geometric Brownian motion model	J3.01
K1 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for domestic portfolios (geometric averages)	K1.01
K2 Position, diversified, and undiversified VAR/COV VaR@95% confidence level estimates for foreign portfolios (geometric averages)	K1.01
K3.01 Position, diversified, and undiversified VAR/COV VaR@95% confidence level for Fréchet random walk model	K3.01
K3.02 Position, diversified, and undiversified VAR/COV VaR@95% confidence level for geometric Brownian motion model	K3.02
L1 Incremental historical VaR estimated from delta VaR for domestic portfolios (arithmetic averages)	L1.01
L2 Incremental historical VaR estimated from delta VaR for foreign portfolios (arithmetic averages)	L1.01
L3.01 Incremental historical VaR estimated from delta VaR for Fréchet random walk model (arithmetic averages)	L3.01

L3.02 Incremental historical VaR estimated from delta VaR for geometric Brownian motion model (arithmetic averages)	L3.02
M1 Risk reduction as a function of the number of positions for domestic portfolios	M1.01
M2 Risk reduction as a function of the number of positions for foreign portfolios	M1.01
M3.01 Risk reduction as a function of the number of positions for Fréchet random walk model	M3.01
M3.02 Risk reduction as a function of the number of positions for geometric Brownian motion model	M3.01
N1 Difference between estimates based on aggregate portfolio and sum individual positions for domestic portfolios (% arithmetic averages)	N1.01
N2 Difference between estimates based on aggregate portfolio and sum individual positions for foreign portfolios (% arithmetic averages)	N1.01
N3.01 Difference between estimates based on aggregate portfolio and sum individual positions for Fréchet random walk model	N3.01
N3.02 Difference between estimates based on aggregate portfolio and sum individual positions for geometric Brownian motion model	N3.01
O1 Estimates of component VaR@95% confidence level for domestic portfolios (arithmetic averages)	O1.01
O2 Estimates of component VaR@95% confidence level for foreign portfolios (arithmetic averages)	O1.01
O3.01 Estimates of component VaR@95% confidence level for Fréchet random walk model	O3.01
O3.02 Estimates of component VaR@95% confidence level for geometric Brownian motion model	O3.01
P1 Estimates position VaR@95/component VaR@95 ratio for domestic portfolios (arithmetic averages)	P1.01
P2 Estimates position VaR@95/component VaR@95 ratio for foreign portfolios (arithmetic averages)	P1.01
P3.01 Estimates position VaR@95/component VaR@95 ratio for Fréchet random walk model (arithmetic averages)	P3.01
P3.02 Estimates position VaR@95/component VaR@95 ratio for geometric Brownian motion model (arithmetic averages)	P3.01

Q1 Estimates position VaR@95/component VaR@95 ratio for domestic portfolios (% geometric averages)	Q1.01
Q2 Estimates position VaR@95/component VaR@95 ratio for foreign portfolios (% geometric averages)	Q1.01
Q3.01 Estimates position VaR@95/component VaR@95 ratio for Fréchet random walk model (% geometric averages)	Q3.01
Q3.02 Estimates position VaR@95/component VaR@95 ratio for geometric Brownian motion model	Q3.01
Y1 Country databases classifications and compositions	Y1
Z1.01 Average beta estimates for Australia	Z1.01
Z1.02 Average beta estimates for Brazil	Z1.02
Z1.03 Average beta estimates for Chile	Z1.03
Z1.04 Average beta estimates for France	Z1.04
Z1.05 Average beta estimates for Germany	Z1.05
Z1.06 Average beta estimates for Hong Kong	Z1.06
Z1.07 Average beta estimates for India	Z1.07
Z1.08 Average beta estimates for Indonesia	Z1.08
Z1.09 Average beta estimates for Ireland	Z1.09
Z1.10 Average beta estimates for Israel	Z1.10
Z1.11 Average beta estimates for Italy	Z1.11
Z1.12 Average beta estimates for Japan	Z1.12
Z1.13 Average beta estimates for Mexico	Z1.13
Z1.14 Average beta estimates for New Zealand	Z1.14
Z1.15 Average beta estimates for Singapore	Z1.15
Z1.16 Average beta estimates for South Africa	Z1.16
Z1.17 Average beta estimates for South Korea	Z1.17
Z1.18 Average beta estimates for Spain	Z1.18
Z1.19 Average beta estimates for Sweden	Z1.19
Z1.20 Average beta estimates for Switzerland	Z1.20
Z1.21 Average beta estimates for Taiwan	Z1.21
Z1.22 Average beta estimates for Thailand	Z1.22
Z1.23 Average beta estimates for Turkey	Z1.23
Z1.24 Average beta estimates for United Kingdom	Z1.24
Z1.25 Average beta estimates for United States	Z1.25

Z2.01 Average beta estimates for companies with highest market capitalization	Z2.01
Z2.02 Average beta estimates for companies with second highest market capitalization	Z2.02
Z2.03 Average beta estimates for companies with third highest market capitalization	Z2.03
Z2.04 Average beta estimates for companies with fourth highest market capitalization	Z2.04
Z2.05 Average beta estimates for companies with fifth highest market capitalization	Z2.05
Z2.06 Average beta estimates for companies with sixth highest market capitalization	Z2.06
Z2.07 Average beta estimates for companies with seventh highest market capitalization	Z2.07
Z2.08 Average beta estimates for companies with eighth highest market capitalization	Z2.07
Z2.09 Average beta estimates for companies with ninth highest market capitalization	Z2.09
Z2.10 Average beta estimates for companies with tenth highest market capitalization	Z2.10
Z3.01 Beta estimates for Fréchet random walk model	Z3.01
Z3.02 Beta estimates for geometric Brownian motion model	Z3.02
AA.1 Summary of overall risk reduction – Domestic portfolios	AA.1
AA.2 Summary of overall risk reduction – Simulation models, mixed-foreign portfolios, and case averages	AA.2
AA.3 Table summary averages over risk measurements and risk reduction ratios	AA.3
AA.4 Summary averages for component VaR forecasts	AA.3
AA.5 Summary averages for component VaR forecasts	AA.4
AB2.01 Average weighted factor betas: portfolio group MC1	AB2.01
AB2.02 Average weighted factor betas: portfolio group MC2	AB2.01
AB2.03 Average weighted factor betas: portfolio group MC3	AB2.01
AB2.04 Average weighted factor betas: portfolio group MC4	AB2.01
AB2.05 Average weighted factor betas: portfolio group MC5	AB2.02
AB2.06 Average weighted factor betas: portfolio group MC6	AB2.02
AB2.07 Average weighted factor betas: portfolio group MC7	AB2.02

AB2.08 Average weighted factor betas: portfolio group MC8	AB2.02
AB2.09 Average weighted factor betas: portfolio group MC9	AB2.03
AB2.10 Average weighted factor betas: portfolio group MC10	AB2.03
AC2.01 Average risk measurements: portfolio group MC1	AC2.01
AC2.02 Average risk measurements: portfolio group MC2	AC2.01
AC2.03 Average risk measurements: portfolio group MC3	AC2.01
AC2.04 Average risk measurements: portfolio group MC4	AC2.02
AC2.05 Average risk measurements: portfolio group MC5	AC2.02
AC2.06 Average risk measurements: portfolio group MC6	AC2.02
AC2.07 Average risk measurements: portfolio group MC7	AC2.03
AC2.08 Average risk measurements: portfolio group MC8	AC2.03
AC2.09 Average risk measurements: portfolio group MC9	AC2.03
AC2.10 Average risk measurements: portfolio group MC10	AC2.04

List of Figures

R1 Variance/covariance VaR at the 95% confidence level for domestic portfolios	R1
R2 Variance/covariance VaR at the 95% confidence level for foreign portfolios	R1
R3 VAR/COV VaR @ 95% confidence level for Fréchet random walk model and geometric Brownian motion model	R3 & S3
S1 Maximum portfolio loss for domestic portfolios	S1
S2 Maximum portfolio loss for foreign portfolios	S1
S3 Maximum portfolio loss for Fréchet random walk model and geometric Brownian motion model	R3 & S3
T1 Historical VaR at the 95% confidence level for domestic portfolios	T1
T2 Historical VaR at the 95% confidence level for foreign portfolios	T2
T3 Historical VaR @ 95% confidence level for Fréchet random walk model and geometric Brownian motion model	T3 & U3
U1 Expected shortfall at the 95% confidence level for domestic portfolios	U1
U2 Expected shortfall at the 95% confidence level for foreign portfolios	U2
U3 Expected shortfall @ 95% confidence level for Fréchet random walk model and geometric Brownian motion model	T3 & U3
V1 Ratio of diversified portfolio VaR to aggregate VaR from individual positions for domestic portfolios	V1
V2 Ratio of diversified portfolio VaR to aggregate VaR from individual positions for foreign portfolios	V2
V3 – Ratio of diversified portfolio VaR to aggregate VaR from individual positions for Fréchet random walk model and geometric Brownian motion model	V3 & W3
W1 Component VaR at the 95% confidence level for domestic portfolios	W1
W2 Component VaR at the 95% confidence level for foreign portfolios	W2
W3 Component VaR @ 95% confidence level for Fréchet random walk model and geometric Brownian motion model	V3 & W3
X1 Ratio of position VaR at the 95% confidence level to component VaR at the 95% confidence level for domestic portfolios	X1
X2 Ratio of position VaR at the 95% confidence level to component VaR at the 95% confidence level for foreign portfolios	X2

X3 Ratio of position VaR @ 95% confidence level to component VaR @ 95% confidence level for for Fréchet random walk model and geometric Brownian motion model

X3

Introduction

Most studies of the benefits of diversification focus on portfolio risk measures that are functions of the properties of the center region of a log-return distribution. The distribution of the log-returns of an equity portfolio should be at least approximately Gaussian if the portfolio is considered diversified. This is because the consequences of the benefits of the diversification effects of a well-diversified portfolio will have “averaged” away the significance of the extreme values and extreme dependencies. Statistically, this is just another way of stating the central limit theorem for a sum of centered and normalized sums. If the portfolio is diversified and the log-returns are approximately jointly Gaussian, the variance/covariance VaR forecast is a coherent risk measure. In general, even if the returns are fat-tailed, there will be diversification benefits, justifying the use of the simple model to implement VaR and expected shortfall estimators to be implemented using the historical risk measurement method. The expected shortfall is, in general a coherent risk measure, but the historical VaR method may not be coherent. This study concerns an empirical analysis of the statements and concepts just mentioned. Specifically, the analysis concerns the quantification of the extent and nature of the risk reduction arising as a consequence of the effects of diversification on a number of different categories of equity portfolios. The risk reduction will be measured using both an unexpected and an exceptional (or extreme) risk metric, which were the value at risk (VaR) and the expected shortfall, respectively. Two simulation models will be used as the reference models namely: Fréchet random walk (FRW) and geometric Brownian motion model (GBM).

As an extension to the results presented, the empirical risk mapping experiment will be investigated, and risk mapping is the next step for portfolio with extremely large numbers of positions from numerous financial markets in numerous different country. The idea is risk mapping may be able to simplify the risk measurement process for portfolios with extreme large numbers of position, where the position may be changing often. The analysis is static, implying that the effects of liquidity changes and portfolio composition changes will not be considered.

PART ONE

LITERATURE REVIEW

A review of the literature relating to portfolio diversification, coherent risk measures, risk mapping and the setting of risk limits is provided in Part one. Examining the nature and the sources of portfolio risks during normal and abnormal market conditions are the focuses of this thesis. The literature review creates the context within which these areas of the finance literature have developed. Although the principles behind portfolio diversification were firmly established in the finance literature in the 1950s, it was not until Grubel (1968) that diversification in an international context was formally considered. Chapter 1 reviews the early literature relating to portfolio diversification in an international setting and the effects of the increasing integration of world financial markets. The October 1987 global stock market crash highlighted for many, the extent to which world equity markets had become increasingly integrated and the merits of international diversification given this comovement and the relative transaction costs. Chapter 2 considers the assumption of normal distributions of returns underlying stock prices and the use of linear VaR models as opposed to other VaR models such as historical VaR or Monte Carlo simulations. Chapter 3 considers the various approaches to selecting risk factors and risk mapping and the importance of setting risk limits as a supplement to the one number VaR . This is useful as then institutional investors and international equity investors can actively use it for portfolio and risk management purposes. Besides, VaR itself has serious fundamental flaws. It is based on volatilities and correlations that can work in normal market conditions but break down in times of market crises.

Chapter 1: Merits of International Diversification

The issue of portfolio diversification in world equity markets became prominent with the article of Grubel (1968). Chapter 1 reviews some of the important articles to appear in the early literature; particularly the benefits of domestic diversification using naïve diversification, the establishment of the necessary and sufficient conditions for ascertaining gains from portfolio diversification in an international setting and the effects of an increasingly globalized world. The relationship between diversification and coherent risk measures is also briefly discussed.

1.1 Benefits of Domestic Diversification Using Naïve Diversification

Naïve or simple diversification implies that an equal proportion of wealth is allocated to each security in the portfolio. Naïve diversification can be defined as “*not putting all your eggs in one basket*.” Naïve diversification ignores the covariance between securities. In general, diversification works best when the asset exhibit zero or low correlations among each other. Also diversification works well when there are a number of short and long positions.

For a portfolio composed of n securities, $w_i = 1/n$ for $i=1,2,\dots,n$, which is due to the equal weight assumption inherent to naïve diversification (Elton, Gruber, Brown and Goetzmann, 2003, p. 51-61; Francis, 1991, sections 9-1 through 9-3; and Francis and Archer, 1979, section 9.1). This implies that the variance of the log-returns of the portfolio can be rewritten as follows:

$$\begin{aligned} VAR_{t_0}[R(t)] &= \sum_{i=1}^n \sum_{j=1}^n w_i w_j COV_{t_0}[r_i(t), r_j(t)] \\ &= \frac{1}{n^2} \sum_{i=1}^n \sum_{j=1}^n COV_{t_0}[r_i(t), r_j(t)] \\ &= \frac{1}{n^2} \left(\sum_{i=1}^n VAR_{t_0}[r_i(t)] + \sum_{i=1}^n \sum_{j=i+1}^n COV_{t_0}[r_i(t), r_j(t)] \right) \end{aligned}$$

noting that $VAR_{t_0}[r_i(t)] = COV_{t_0}[r_i(t), r_i(t)]$.

Now let the following relationships hold for the variances and covariances:

$$VAR_{t_0}[r_i(t)] < VAR$$

for $i=1,2,\dots,n$ and

$$COV_{t_0}[r_i(t), r_j(t)] < COV$$

for $i=1,2,\dots,n$ and $j=i+1,2,\dots,n$; where VAR and COV are bounded positive constants.

$$VAR < \infty \text{ and } COV < \infty,$$

respectively. VAR and COV may be viewed as the average variance and average covariance. First, the case where $COV = 0$, which implies the log-returns of the n securities are uncorrelated:

$$VAR_{t_0}[R(t)] = \frac{1}{n^2} \sum_{i=1}^n VAR = \frac{1}{n} VAR$$

As the number of securities n increases, i.e. $n \rightarrow \infty$;

$$VAR/n \rightarrow 0, \text{ implying } VAR_{t_0}[R(t)] \rightarrow 0$$

This implies that the portfolio variance approaches zero if there are enough uncorrelated assets. If $COV \neq 0$, which is the case for correlated assets and using these relationships:

$$VAR_{t_0}[r_p(t)] < \frac{1}{n^2} (nVAR + n(n-1)COV)$$

or

$$VAR_{t_0}[r_p(t)] < \frac{1}{n} (VAR + (n-1)COV).$$

As the number of securities n increases, i.e. $n \rightarrow \infty$;

$$VAR/n \rightarrow 0, (n-1)/n \rightarrow 1 \text{ and } (n-1)COV/n \rightarrow COV.$$

One aspect of the interpretation of this comment is that the cumulative contribution of the variance terms becomes negligible. The sum of the variance terms is referred to as the firm-specific risk or diversifiable risk. Another aspect of this comment is that the cumulative of the covariance terms does not become negligible. The cumulative effect of the covariance terms is referred to as the market-specific risk or nondiversifiable risk.

Rearranging the above expression for the value of the portfolio illustrates the effects of diversification:

$$VAR_{t_0}[r_p(t)] < \frac{1}{n}(VAR - COV) + COV$$

The first term represents $1/n$ times the difference between the average variance of the log-returns of the individual securities VAR and average covariance of the log-returns of the individual securities COV . The first term is reduced as securities are added to the portfolio, which illustrates the effects of diversification. The second term represents average covariance of the log-returns of the individual securities COV . The minimum portfolio variance for correlated assets may be obtained for portfolios with very large numbers of positions, and is equal to the average covariance between all the individual securities (Dalle Molle, 2003).

Naïve diversification using 15 to 20 randomly selected stocks can reduce the risk of a portfolio by approximately 50 percent (on the average). The diversification benefits with respect to risk reduction of adding more stocks is insignificant after 15 to 20 stocks have been randomly included in a portfolio. This observation is referred to as superfluous diversification. The following table illustrates the effects of diversification for United States (U.S.) equities listed on the New York Stock Exchange (reproduced from Elton, Gruber, Brown and Goetzmann, 2003, p. 59).

Table 1.1 – Portfolio Diversification Effects	
Number of Securities	Expected Portfolio Variance
1	46.619
2	26.839
4	16.948
6	13.651
8	12.003
10	11.014
12	10.354
14	9.883
16	9.530
18	9.256
20	9.036
25	8.640
30	8.376
35	8.188
40	8.047
50	7.849
75	7.585
100	7.453
150	7.321
200	7.255
250	7.216
500	7.137
1000	7.097
Infinity	7.058

Note that the average equity variance was 46.619 and the average covariance between the equity was 7.058.

1.2 Comovements between World Equity Markets

In this section the necessary condition for ascertaining gains from portfolio diversification in an international setting is considered. The necessary condition is that the correlation coefficients between world equity markets must be less than the correlation coefficients between domestic assets – otherwise one can obtain the risk-reduction benefits of portfolio diversification by investing in the domestic market alone. Grubel (1968) laid the theoretical foundations for portfolio diversification in an international setting. Although Markowitz (1952) and Sharpe (1964) had clearly established the tenets of portfolio theory and developed selection techniques for portfolio optimization, it was not until Grubel (1968) that international diversification

were formally considered in the literature. Grubel (1968) highlighted that those investors who did not consider foreign assets were ignoring a potentially important source of low correlation.

Grubel (1968) used the special case of a two-country two-asset investment model, where as long as less than perfect correlation exists between the two countries, diversification of investment will benefit investors. Grubel's finding offered nothing particularly new relative to portfolio optimization except that it highlighted the importance of considering international assets. Further, the outcome of the special case is unlikely to hold when there is more than one domestic asset and diversification internally is an option. Grubel's empirical study examined the potential gains to U.S. investors from international diversification which he found to be potentially large. Grubel's investigation of portfolio diversification provided a descriptive explanation for the need for continued international capital flows.

Subsequent authors starting with Levy and Sarnat (1970) looked at international portfolio diversification normatively. Levy and Sarnat (1970) used efficient frontiers and the market equilibrium model developed by Litner (1965) and Sharpe (1964) to determine the proportion of investment in each of the various markets in their sample, at different interest rates. Levy and Sarnat (1970) were able to clearly illustrate the benefits accrue to the U.S. investor for diversifying outside the domestic market. However, they added that there were only marginal benefits for moving from a U.S. stock only portfolio to one containing stocks from high income, common market or Western European countries. Only when the U.S. investor diversified to include countries such as Japan and South Africa and the developing countries of South America and Asia that a significant improvement in the efficient frontier resulted. These countries tend to have lower correlations with the U.S. market, and thus are able to provide the benefits of international diversification to the investor.

Grubel and Fadner (1971) pointed out two important influences not encountered by U.S. assets which might lead to lower inter-country correlation coefficients and make foreign assets attractive to U.S. portfolio holders. First, returns on foreign assets are influenced by business cycles, natural and man-made catastrophes and government policies whose effects are limited to or strongly felt in the economies of the affected

countries. Second, the capital value changes of assets caused by exchange rate variation influence the variance of returns on foreign assets. Using the *ex post* variance-covariance matrices of returns for industry sub-indices from U.S., United Kingdom (U.K.), and West German stock indices, Grubel and Fadner (1971) attempted to measure the significance of those two factors. They discovered that the pairwise inter-country correlation coefficients were positively low and lower than intra-country coefficients. Solnik (1974) also revealed that inter-country differences in business cycles enhance international portfolio diversification. Solnik (1974) examined the level of risk reduction as more stocks are included in a portfolio. For portfolios that contain assets from outside the domestic market, the risk reduction was greater than for portfolios that contain only domestic assets. Even after accounting for exchange rate fluctuations, the risk was still less for portfolios that contain foreign assets.

Implicit in these early studies, is the hypothesis that international diversification will lead to larger gains than ordinary 'pure diversification' gains as a result of increasing the universe of available securities within a single country. The early studies can also be summarized by their focus on the gains for foreign market diversification from a U.S. investor perspective. Lessard (1974) summarized the early tests as:

"The early tests of Grubel (1968) and Levy and Sarnat (1970) relied on low correlations between the national markets and the performances of *ex post* efficient internationally diversified portfolios to establish these greater gains. However, the low correlations among markets may or may not indicate large potential gains relative to domestic diversification depending on the correlations among groups of stocks in each market and the *ex post* efficient portfolios are, at best, indicative of gains." (p. 379).

Research by Agmon (1972) and Lessard (1976) examined the concept of segmented versus integrated capital markets. Lessard (1973, 1974) highlighted the difference between gains from domestic versus inter-country portfolio diversification alluded to above. These two areas contributed a new angle to portfolio diversification in an international setting and were likewise important in developing literature in this area. They are considered below.

Agmon (1972) highlighted that the literature up until that point had considered national capital markets on a segmented markets approach, where national capital markets are treated as separate entities, almost independent to each other like Grubel's two-country, two-asset model. As such, one might naturally assume low correlation

coefficients between markets. Agmon (1972) noted that “different currency areas separated political organizations and trade barriers have been given as *a priori* evidence for the segmentation of the international capital market.” (p. 839). Agmon (1972) argued that the alternative hypothesis, that prices of capital assets in the global capital market behave as if there is one multinational perfect capital market should also be considered and that an examination of the behavior of capital asset prices reveal that the price behavior is consistent with the one market hypothesis.

In terms of Grubel’s two-country, two-asset framework, Agmon (1972) argued that, while still important, the interesting question relates to how free trade, deregulation between two countries impact on the composition of investment portfolios. This is an issue that could not be examined by Grubel (1968) as the full risk-return profile for each of the markets is not captured by the market index used in his study. Agmon (1972) emphasized that while it is correct in terms of Grubel’s theoretical two-country, two-asset world to look at portfolio diversification in terms of correlation, the empirical analysis conducted by him was based on market indices which comprised of many shares and thus are only close approximations to diversified portfolios. In comparing two portfolios, domestic and foreign, the relevant measure is a function of the covariance between the return of any given asset and the return on the investor’s portfolio. It may be that, even in situations like the one presented by Grubel (1968), investors cannot benefit from diversification between countries.

Agmon (1972) disagreed with Grubel’s revelation that, given equity markets are segmented, correlation coefficients substantially less than one between any index of non-U.S. equity markets and the U.S. market index would give U.S. investors potential welfare gains from international diversification, the benefits accruing once the barriers among equity markets were removed. Because composite market indices do not capture all the possibilities for diversification within a local market, the fact that two indices are weakly correlated does not necessarily imply the superiority of international diversification over internal diversification. Consequently, one cannot be sure that internal diversification would not give the same (or better) efficient sets. The one market hypothesis may have an advantage here since it implies that all the potential gains from inter-country and internal diversification are already reflected in the current prices of capital assets traded on the world market. Using individual stock returns from

four countries, Agmon (1972) outlined a framework of a single equity market and demonstrated that price behavior in these countries was consistent with the single market hypothesis. In spite of the barriers that exist in multinational equity markets, there was a strong relationship among the four equity markets. In particular, Agmon (1972) noted that the price movement in the majority of German shares resembled U.S. shares. Agmon (1972) highlighted the importance of not simply accepting the segmented markets hypothesis.

McDonald (1973) also cautioned the need in interpreting the studies of Grubel (1968) and Levy and Sarnat (1970).

“In the context of portfolio choice these results must be interpreted with caution, as one cannot demonstrate with *ex post* returns on market indices alone the extent to which international diversification is desirable. The important question is whether efficient (*ex ante*) multinational portfolios of individual securities dominate efficient portfolios constructed from stocks in a single country, and on this issue the evidence is limited.” (pp. 1161-1162).

McDonald (1973) argued that the issue also depends on the effective degree of integration of the world's equity markets. McDonald (1973) suggested reality falls somewhere between the two hypotheses discussed by Agmon (1972): the fully-integrated one-market hypothesis; and the fully-segmented market hypothesis, because of impediments in multinational investment. In the former, the capital asset pricing model (*CAPM*) of capital market equilibrium would include portfolios of domestic common stocks from a number of nations lying along a common capital market line; for the latter, one would expect a unique capital market line in each national market.

“In fully-integrated markets, a portfolio which purchased common stocks in a second country would gain only the ‘pure diversification’ advantage of access to a larger part of the total universe of securities. The segmented –market hypothesis implies potential advantages from international investment beyond those associated with pure diversification, as more favorable ratios of expected return to non-diversifiable risk may be available in foreign markets.” (McDonald, 1973, p.1162).

McDonald (1973) used the investment performance of French mutual funds as examples of portfolios diversified outside the domestic market and discovered that the funds generally produced superior risk-adjusted returns than funds invested only in domestic assets.

Lessard (1976) also examined the issue relating to segmented versus integrated markets. The following passage captures the importance of segmented versus integrated markets in establishing the theory of portfolio diversification in an international context.

“The low correlations between the country factors represent the key to gains from international diversification. The magnitude of these gains will depend, however, on whether markets are segmented or integrated internationally. In the former case, assuming the validity of the capital asset pricing model, prices and expected returns are determined by the undiversifiable risk of each security in the context of the appropriate national portfolio. In the latter, prices and expected returns are determined by the undiversifiable risk of each security in the context of the world portfolio. With fully integrated markets, the advantage to international diversification is a pure diversification effect, a reduction in the non-systematic risk of the portfolio. With fully segmented markets gains might be even greater, since prices would adjust to reflect the fact that some previously undiversifiable risk was becoming diversifiable.” (Lessard, 1976, p.34).

Unfortunately, it is very difficult to actually determine which of the two conflicting theories most accurately describes portfolio diversification in an international setting. The reality lies somewhere between the two extremes.

Lessard (1973) studied the communality among returns within individual countries relative to the communality across countries. Using an Investment Union (IU) approach for four Latin American countries, multivariate analysis of the return structure for individual stocks was used to investigate the likelihood of greater gains for inter-country diversification over domestic diversification. For gains from inter-country diversification to be greater, two important conditions must be satisfied. Firstly, returns within each country must share a common element of variance, and secondly, the common elements for each country must be largely independent of those from the other countries. Using principal component analysis, Lessard (1973) concluded:

“...that even though the principal components for each country are not absolutely independent, it is possible to explain an average of 93 per cent as much variance for each country as is explained by the principal components with four completely *independent* factors.” (p. 625).

This is an important finding as it again highlights the benefit of inter-country diversification over domestic diversification. It shows that while the benefits of domestic diversification are limited due to the common trend in stock returns, potential benefits are much greater by diversifying outside the domestic market because common trends are much harder to find between countries. Lessard (1973) attributes this to different levels of economic activity at different times and the different monetary and

fiscal policies of different governments. Though different methodologies were applied, Lessard's findings are consistent with what McDonald (1973) found for French mutual funds.

Lessard (1974) studied the benefits of diversifying outside the domestic market in contrast to domestic diversification by considering the stochastic process generating returns. Lessard (1974) highlighted that in previous studies which have used a *CAPM* market model, national markets have been found to be characterized by a strong market factor consistent with a single-factor stochastic process. Because of the linkages between national markets, one would expect some relationship between market factors in different countries. However, Lessard (1974) found that only a small proportion of the variance of national portfolios is similar in an international context. Lessard (1974) demonstrated the considerable risk reduction available through portfolio diversification in an international setting.

The literature reviewed in this section was important in establishing portfolio diversification in an international setting. Grubel (1968), Levy and Sarnat (1970), Grubel and Fadner (1971) and Solnik (1974) all highlighted that lower correlation coefficients between national equity markets meant that additional benefits were available to investors who diversified outside the domestic market. Agmon (1972), McDonald (1973) and Lessard (1976) looked at the segmented versus integrated market hypothesis, providing a context in which the early studies of portfolio diversification in an international context should be examined. They showed that it is essential to consider the assumptions being made in testing the benefits of portfolio diversification in an international setting. Lessard (1973, 1974) provided further evidence to support the notion of additional benefits offered by portfolios diversified outside the domestic market, over portfolios with domestic assets only.

1.3 Integration of World Equity Markets

The fundamental rationale for international portfolio diversification is that it expands the opportunities for gains from portfolio diversification beyond those that are available through domestic investment. However, if international stock market correlations are higher than normal as found in empirical literature (refer to section 1.2), then

international diversification will fail to yield the promised gains and correlation breakdowns will occur. This is especially true during times of crises when the market is in stress with low liquidity. In this section the worldwide impact of the 1987 stock market crash, the 1997 Asian crises and the long-term linkages between equity markets using the Vector Autoregression (VAR) technique are examined. It will be interesting to see to what extent globalization has impacted on the linkages between equity markets. If strong linkages between markets are found then the rationale for diversifying outside the domestic market to benefit from risk reduction through portfolio diversification becomes questionable.

The October 1987 stock market crash attracted reasonable interest not only in the academic literature, but also from regulatory authorities due to its worldwide scope. The findings in the early literature revealed low comovement between world equity markets. The 1987 crash raised the obvious question of whether world equity markets had become more integrated? Table 1.2 shows that prices in October 1987 dropped all around the world.

Table 1.2 STOCK PRICE INDEX PERCENTAGE CHANGES IN MAJOR MARKETS: CALENDER YEAR 1987 AND OCTOBER 1987				
	Local Currency Units		U.S. Dollars	
Countries	1987	October	1987	October
Australia	-3.6	-41.8	4.70	-44.9
Austria	-17.6	-11.4	0.70	-5.8
Belgium	-15.5	-23.2	3.1	-18.9
Canada	4.0	-22.5	10.4	-22.9
Denmark	-4.5	-12.5	15.5	-7.3
France	-27.8	-22.9	-13.9	-19.5
Germany	-36.8	-22.3	-22.7	-17.1
Hong Kong	-11.3	-45.8	-11.0	-45.8
Ireland	-12.3	-29.1	4.7	-25.4
Italy	-32.4	-16.3	-22.3	-12.9
Japan	8.5	-12.8	41.4	-7.7
Malaysia	6.9	-39.8	11.7	-39.3
Mexico	158.9	-35.0	5.5	-37.6
Netherlands	-18.9	-23.3	0.3	-18.1
New Zealand	-38.7	-29.3	-23.8	-36.0
Norway	-14.0	-30.5	1.7	-28.8
Singapore	-10.6	-42.2	-2.7	-41.6
South Africa	-8.8	-23.9	33.5	-29.0
Spain	8.2	-27.7	32.6	-23.1
Sweden	-15.1	-21.8	-0.9	-18.6
Switzerland	-34.0	-26.1	-16.5	-20.8
United Kingdom	4.6	-26.4	32.5	-22.1
United States	0.5	-21.6	0.5	-21.6

Reproduced from Kamphuis, Kormendi and Watson (1989, p. 37).

The Asian turmoil of 1997 erased almost three-fourths of the dollar capitalization of the equities markets in Indonesia, Korea, Malaysia, the Philippines and Thailand. By the end of 1997, many loans became non-performing and the crisis spread through Southeast Asia after the Thai government abandoned its support of the baht as

exhibited by these percentage declines in the foreign exchange rates of a number of Southeast Asia countries: the Korean won fell 47.44 percent, the Indonesian rupiah fell 55.9 percent, the Malaysian ringgit fell 34.8 percent and the Philippine peso fell 28.3 percent. The Korean companies: Hanbo Steel Group and the Kia Car Company both went bust. Many of the top ten banks in the region became technically insolvent. The Hong Kong investment bank Peregrine Investments filed for bankruptcy with debts of US\$400 million (Dalle Molle, 2003). The presence of contagion or inter-dependence among economies of a certain region becomes important with the diminishment of the advantages to investors of international diversification.

Jeon and Von Furstenberg (1990) argued that the increasing comovement between equity markets might be the result of two things. It may be caused by the decreasing regulation of world financial markets and the resultant increase in integration which has led to an increase in the efficiency with which capital is allocated and news is processed worldwide. Alternatively, world equity markets may just be reacting increasingly to each other even if there are no news developments of global economic significance that would account for such comovement. Regardless of the explanation, if markets are indeed subject to greater comovement, then the benefit of diversifying outside the domestic market will be reduced. Jeon and Von Furstenberg (1990) studied the changes in price relations among the world's major stock markets that might have been precipitated by the crash of October 1987.

Using the Vector Autoregression (VAR) technique, Jeon and Von Furstenberg (1990) focused on the correlation of daily price movements from 1986 to 1988 for the New York, Tokyo, London and Frankfurt stock markets. The 35-month period is divided into two sub periods (January 6/7, 1986 to October 13/14, 1987, and October 21/22, 1987, to November 24/25, 1988) to study whether there have been changes in interrelationships among stock prices in the major world equity markets since the stock market crash of October 1987. Their findings are worth noting despite the short time study period and the small sample. They discovered that the extent of international comovement in stock indices has increased significantly since the 1987 October stock market crash.

Espitia and Santamaria (1994) also used the VAR technique to examine the linkages between world equity markets. Using daily data during the period of 1987 to 1992, their sample consisted of indices for the stock exchanges of Japan, Spain, Italy, Germany, France, U.K. and the U.S.. The early studies of Grubel (1968) and others argued that diversification reduces risk without sacrificing expected return but Espitia and Santamaria (1994) emphasized that to justify this argument, a prerequisite is needed: that is, capital markets must be independent in the process of price formation. If the markets move in parallel, then the opportunities for diversification are eliminated. The transmission of shocks in one market to other markets implies that linkages between markets exist which might reduce the benefits of international portfolio diversification. They found that diversification outside the domestic market does not appear to have an excessive economic rationale. Only if diversification is implemented by choosing stocks whose differential characteristics give them a specific behavior relative to the local stock market on which they are quoted will there be some use in such diversification. They also found that the effects of a shock to the New York market last longer in the period from 1987 to 1992 (up to four days) than in the 1980 to 1985 period (two days). Like Jeon and Von Furstenberg (1990), this finding illustrates that the comovements of the markets have increased.

1.4 Coherent Risk Measures and Value At Risk (VaR)

Coherent risk measures refer to risk measures such as the expected shortfall, which is the expected loss given a loss greater than VaR occurs. Artzner, Delbaen, Eber and Heath (1999) define a risk measure as been coherent if it satisfies the following conditions i.e. letting a set V be real-valued random variables and a function

$$\rho: V \rightarrow \mathbb{R}:$$

- 1) Translation invariance: adding cash to the portfolio decreases its risk by the same amount. This property is intuitive, only risk is measured in terms of the final net worth rather than changes in value i.e.

$$X \in V, \Rightarrow \rho(X+a) = \rho(X) - a .$$

- 2) Sub-additivity: the risk of the sum of sub-portfolios is smaller or equal than the sum of their individual risks, in other words merging of portfolios should not create additional risk. Sub-additivity ensures that a risk measure behaves reasonable when aggregating positions. Sub-additivity could also be a matter of concern for regulators, where firms might be motivated to break up into affiliates to satisfy capital requirements. i.e.

$$X, Y, X+Y \in V \Rightarrow \rho(X+Y) \leq \rho(X) + \rho(Y) .$$

- 3) Positive homogeneity of degree 1: if the size of every position in a portfolio is doubled, the risk of the portfolio should be twice as large i.e.

$$X \in V, h > 0, hX \in V \Rightarrow \rho(hX) = h\rho(X) .$$

Note that this rules out liquidity effects associated with portfolio that have large amounts in any given individual position.

- 4) Monotonocity: if losses in portfolio A are larger than losses in portfolio B for all possible risk factor return scenarios, then the risk of portfolio A is higher than the risk of portfolio B i.e. $X \in V, X \geq 0 \Rightarrow \rho(X) \geq 0$.

Properties (2) and (3), which refer to sub-additivity and homogeneity, respectively, imply that the convexity of the risk measure ρ and this corresponds to risk aversion on the part of regulators/supervisors.

Generally, VaR is not regarded as a coherent risk measure even though it satisfies the properties of translation invariance, positive homogeneity and monotonocity. According to Artzner, Delbaen, Eber and Heath (1999), this is because: “

- a) VaR does not behave nicely with respect to the addition of risks, even independent ones, thereby creating severe aggregation problems.
- b) The use of VaR does not encourage and, indeed, sometimes prohibits diversification because VaR does not take into account the economic consequences of the events, the probabilities of which it controls.” (p. 218).

In short, VaR does not satisfy the sub-additivity property. There are situations where a portfolio can be split into sub-portfolios such that the sum of the $VaRs$ of the sub-portfolios is smaller than the VaR of the total portfolio. This may cause problems if the risk-management of a financial institution is based on VaR limits for its individual trading books. On this point, Artzner, Delbaen, Eber and Heath (1999) argued that if quantiles were computed under a distribution for which all prices are jointly normally distributed which is discussed in more detail in section 2.1, then VaR is a coherent risk measure since the quantiles do satisfy the sub-additivity condition requiring probabilities of exceedence to be smaller than 0.5 i.e. $\sigma_{X+Y} \leq \sigma_X + \sigma_Y$ for each pair of random variables. Since for a normal random variable X , the VaR is:

$$VaR_\alpha(X) = -(E_p[X] + \Phi^{-1}(\alpha) \cdot \sigma_p(X))$$

with Φ the cumulative standard normal distribution and since $\Phi^{-1}(0.5) = 0$, the sub-additivity condition is met.

In fact, if one does not intend to aggregate risks computed by independent units but rather to allocate risk, then VaR being coherent is unnecessary because one can use the incremental VaR or $IVaR$ (Mina and Xiao, 2001).

1.5 Conclusions

If world equity markets are at least partially integrated, there will be some incentive for investors to diversify outside the domestic market, depending on the comovement between assets in the domestic market. The increasing integration of world equity markets however tends to offset these incentives to diversify outside the domestic market. In the first section, the finding in the early literature that markets are partially integrated was confirmed.

The Vector Autoregression (VAR) methodology is suitable for testing the transmission mechanism between equity markets and capturing the linkages and efficiency between markets. Studies that have employed the VAR technique were reviewed in the second section. The results of these studies have generally found significant linkages between equity markets which mean comovement between these markets is greater than the early literature suggests. The increasing integration of equity markets might explain this. The evidence from testing in this section questions the rationale for investing outside the domestic market to reduce risk in the portfolio.

The properties of coherent risk measures as defined by Artzner, Delbaen, Eber and Heath (1999) is also reviewed namely: translation invariance, sub-additivity, positive homogeneity and monotonicity. Based on these properties, it was demonstrated that VaR is not a coherent risk measure as it violates the condition of sub-additivity. Except if diversification under the assumption of jointly normal distribution of returns works, then only then VaR is a coherent risk measure suggesting the property of sub-additivity is met. VaR been sub-additive is equivalent of saying diversification never increases the level of risk.